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IN THE

Supreme Court of the United States

No. 824

KATIE M. HOWELL, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 825

ESTATE OF J. H. HOWELL, DECEASED, *Petitioner*.

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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ESTATE OF J. H. HOWELL, DECEASED, *Petitioner*.

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable, The Chief Justice and The Associate Justices of the Supreme Court of the United States:

PETITION.

Katie M. Howell, individually, and as Executrix of the Estate of J. H. Howell, deceased, by her counsel, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Fifth Cir-

cuit entered in the above-entitled cases February 8, 1944 (R. 69-75)[1], affirming a decision of The Tax Court of the United States (R. 15-23) sustaining deficiencies in income tax for the calendar year 1939 in the amount of $9,710.18 against Katie M. Howell individually, and in the amount of $9,710.19 against Katie M. Howell, Executrix.

JURISDICTION.

The judgments of the Circuit Court of Appeals sought to be reviewed were entered February 8, 1944. Jurisdiction to issue the writs requested is found in Section 240 of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

1. In dealing with oil and gas properties for Federal tax purposes, should the ownership of the "economic interest" in the petroleum be considered, or should only legal titles be recognized?

2. The decision of the foregoing question will dispose of the ultimate question, which is the length of time Howell owned the interest which was sold to the Buffalo Oil Company.

If Howell owned an "economic interest," as petitioner contends, he owned it for more than eighteen months and the gain on its sale should be taxed as long-term capital gain. If Howell owned nothing when he acquired the right to enter upon and exploit the land, and the thing of value involved is the "lease," rather than the "economic interest," as held by the Court below, the gain is taxable as short-term capital gain.

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[1] References are to the printed record in No. ...., *Katie M. Howell* v. *Commissioner of Internal Revenue*. By stipulation between the parties, only one record has been printed, as the cases are identical and were disposed of on one record and by one opinion by The Tax Court and the Circuit Court of Appeals. In the Circuit Court of Appeals only one record was printed. Two appeals were filed because the income involved was reported on the community property basis by Howell and his wife in separate returns.

Petitioner contends that the only thing of value involved was the "economic interest," or the right to enter upon the land and exploit it for petroleum. The Court below held that the "lease," and not the right to enter upon and exploit the land, is the thing of value involved.

SUMMARY STATEMENT OF MATTER INVOLVED.

Petitioner's husband, J. H. Howell, on October 6, 1937, entered into a "contract" with W. P. Ferguson, under which he was given the right to enter upon certain of Ferguson's land and explore for petroleum. If a well were started by Howell on or before November 21, 1937, a "lease," also executed October 6, 1937, and which was to be placed in escrow, was to be delivered to Howell. Actually, the "lease" was delivered to one of Howell's coowners on October 6, 1937. The "contract" gave Howell all of the rights customarily given by an oil and gas "lease," except the right to defer the drilling of a well by the making of rental payments. (R. 16-17, 39-46.)

On October 26, 1937, Howell entered into an agreement with Consolidated Oil Company whereby he agreed to convey to the company a three-fourths interest in the acreage covered by his "contract" with Ferguson, in consideration of $5,000 in cash and the assumption by Consolidated of all of Howell's obligations under the "contract" with Ferguson, including the obligation to start the well on or before November 21, 1937. (R. 18, 47-48.)

The well was started by Consolidated November 16 or 17, 1937, and the "lease" delivered to petitioner's husband that day. (R. 18, 37.) November 19, 1937, petitioner's husband, J. H. Howell, assigned a three-fourths interest in the "lease" of October 6, 1937, to Consolidated. On the same day, Howell and Consolidated assigned to H. S. Gray all of their interest in the lease insofar as it covered a described tract of land containing twenty acres, more or less. (R. 18, 37, 38.)

On April 10, 1939, petitioner's husband, J. H. Howell, and Consolidated assigned their entire seven-eighths working interest in about half of the land covered by the "lease" to Buffalo Oil Company for $700,000 cash, of which petitioner's husband, J. H. Howell, received $175,000. (R. 18, 38.)

The question for decision is the period of time Howell held the rights which he sold April 10, 1939.

The Tax Court disposed of the case on the theory that the piece of paper called a "lease" was the property sold, rather than the "economic interest" in the petroleum represented by the right to enter upon, explore for and extract the mineral conveyed by the "contract" and the "lease." In other words, it held that ownership of the rights sold dated from the time the formal piece of paper called a "lease" was delivered to Howell, and not from the time Howell actually acquired the "economic interest" in the petroleum. The taxpayer takes the position that the thing sold was an "economic interest" in the petroleum. That "economic interest" was held from October 6, 1937, when Howell acquired the right to enter upon the land and explore for and extract the minerals, which was more than eighteen months prior to the sale. (R. 20-23.)

The Circuit Court of Appeals, without citing a single oil and gas decision, disposed of the case on the ground that the transaction was a sale of oil and gas in place, stating (R. 73):

> "Under the law of Texas, an oil lease is a present sale of oil and gas in place. That is the substance of what taxpayer acquired when the lease in question was delivered. * * * The purchasers did not pay $700,000.00 for an 'economic interest.' They paid $700,000.00 for oil and gas in place, plus the right to take it, as evidenced and made secure to them by the execution of a valid and legal document, to-wit, a lease."

The Circuit Court opinion does not mention *Burnet* v. *Harmel,* 287 U. S. 103, where the taxpayer, in a capital

gain case, made the identical contention as that stated by the Circuit Court. This Court denied the taxpayer's contention and reversed the Fifth Circuit in the *Harmel* case.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRITS.

I.

The decision below is in conflict with Burnet v. Harmel, 287 U. S. 103.

In the *Harmel* case, the taxpayer contended that a bonus received for executing an oil and gas lease on Texas land should be taxed as capital gain because, under Texas law, such a lease was a present sale of oil and gas in place. This Court specifically denied the taxpayer's contention and reversed the Fifth Circuit (56 F. (2d) 153). In discussing leases in states where title to the oil passes only on severance by the lessee, as compared with Texas leases, this Court states (p. 111):

> "The economic consequences to the lessor of the two types of leases are the same. Under both, the payments made by the lessee are consideration *for the right which he acquires to enter upon and use the land for the purpose of exploiting it*, as well as for the ownership of the oil and gas * * *." (Italics supplied.)

In the case at bar, the Circuit Court opinion does not refer to the *Harmel* case and specifically holds (R. 73):

> "Under the law of Texas an oil lease is a present sale of oil and gas in place. That is the substance of what taxpayer acquired when the lease in question was delivered. That is what the taxpayer sold to Buffalo Oil Company. The purchasers did not pay $700,000.00 for an 'economic interest.' They paid $700,000.00 for oil and gas in place, plus the right to take it, as evidenced and made secure to them by the execution and delivery to them of a valid and legal document, to-wit, a lease."

Both the *Harmel* case and the case at bar are capital gains cases. The *Harmel* case held it was immaterial if, as a matter of state law, an oil and gas lease was a present sale of the oil in place. The case at bar turns on the holding that, under Texas law, such a lease is a present sale of oil and gas in place.

It is true that the *Harmel* case did not involve a determination of the length of time the asset was held. However, that case did squarely hold that, for Federal tax purposes, the right involved is the right to enter upon and exploit the land. Howell clearly owned that right for more than eighteen months.

When Consolidated paid Howell $5,000 in cash and assumed the responsibility of drilling the obligation well, it believed Howell owned something. The Court below apparently thinks otherwise.

II.

The decision below is in conflict with numerous decisions of this Court which hold that the burdens and benefits of the taxing statute apply to the person owning the "economic interest," rather than to the person holding legal title to oil and gas property.

Typical of the cases are:

Palmer v. *Bender,* 287 U. S. 551, which holds that the depletion deduction is allowable to the person who has the right to share in the oil produced; that is, by the owner of the "economic interest." In the case at bar, Howell owned the right to share in the oil produced for more than eighteen months.

Anderson v. *Helvering,* 310 U. S. 404, holds that ownership of an "economic interest" is not dependent (p. 411) "upon the particular instrument involved, or upon the formalities of the conveyancer's art."

The case at bar certainly went off on "formalities of the conveyancer's art," and not upon the interests involved.

The *Anderson* case also holds (p. 407):

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."

Stated another way, the ownership of the "economic interest" is the governing factor.

United States v. *Biwabik Mining Co.*, 247 U. S. 116, and *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, both hold that mineral leases are not conveyances of the mineral in place, but are "grants of the privilege of entering upon, discovering, and developing and removing the minerals from the land" (Biwabik, p. 123).

In the case at bar, the petitioner owned the rights mentioned more than eighteen months.

Lynch v. *Alworth-Stephens Co.*, 267 U. S. 364, holds that the right to reduce the mineral to possession is an interest in property.

From the very inception of the income tax, this Court has uniformly held that ownership of the right to share in the mineral produced (which this Court describes as an "economic interest") is the determinative fact with respect to income and to deductions. This is true because the only thing of value is the right to extract the mineral. Legal title without the "economic interest" is valueless.

In the case at bar, the Court below ignores established law and reality and disposes of the case entirely on the length of time legal title was held; this despite the fact that at all times the parties were concerned only with the right to explore for and extract the mineral.

Nothing but confusion will result if, at this late date, cases involving the taxation of oil and gas properties turn on legal title, rather than on "economic interest."

III.

The decision below is in conflict with long-established practice of the Bureau of Internal Revenue.

This is illustrated by General Counsel's Memorandum 2270, Cumulative Bulletin, December, 1927, page 216, which involved an oil lease which was placed in escrow until payment was made by the vendees starting wells at designated places, by development by the vendees, by the maintenance of the properties unencumbered by liens, and by certain payments out of oil . In the event any of the conditions were not fulfilled, title was to revert to the vendors. The General Counsel of the Bureau states:

> "But the contract also clearly contemplates that from the date of delivery in escrow of the executed assignment the vendees are entitled to possession under the lease. The contract is unmistakably clear that the possession to which the vendees are thus entitled upon the delivery in escrow is possession as lessees, and that the vendees have the right to use the properties as their own to the same extent as is customary with a mortgagor. From that time the vendees are entitled to the profits of the lease. (*Tucker* v. *McLaughlin-Farrar Co.*, 36 Okla., 321, 129 Pac., 5.) From that time the vendees have every right of ownership not inconsistent with the security of the vendors, including the risk of loss and the opportunity for profit. (*Miller* v. *Waddingham*, 91 Cal., 377, 27 Pac., 750, 13 L. R. A. 680; *Baker* v. *Bishop Hill Colony*, 48 Ill., 264; *Baldwin* v. *Pool*, 74 Ill., 97.) It is, therefore, evident that under the contract as of the time of delivery in escrow by the vendors of the executed assignment all the beneficial incidents of ownership in the lease passed to the vendees and as of that time the vendees became possessed of such a property in the oil and gas lease as to entitle them to an allowance of a deduction for depletion under section 214(a) 10 or section 234(a)9, Revenue Act of 1921, and the regulations prescribed thereunder. I. T. 2275 (C. B. V-1, 62) and ruling therein cited.

"The delivery in escrow of the assignment of the lease deliverable from escrow to the vendees only upon the happening of the condition stipulated in the escrow agreement results in the retention of the title to the lease by the vendors, but this retention of title is merely as security for payment of the purchase price. The escrow was but a short way of accomplishing the same thing as would be achieved by assigning to the purchaser and taking a mortgage back. After the time when the assignment is delivered in escrow the vendors' rights are merely for the purpose of security and all the beneficial incidents of ownership are in the vendees. Such rights of ownership as the vendors possess are rights of security subordinate and incident to the debt or obligation of the vendees for the purchase price. One possessing only a security or a mortgage interest in oil and gas property can derive no income from the property as such; * * *."

The General Counsel's Memorandum emphasizes and turns on the fact of possession. This is consistent with the holding in *Burnet* v. *Harmel*, 287 U. S. 103, that an oil and gas lease is merely a right to enter upon land and exploit it. Under *Anderson* v. *Helvering*, 310 U. S. 404, that right is not dependent "upon the particular instrument involved."

To say that the rights described in G. C. M. 2270 as above quoted, and as exist in the case at bar, are not the real rights involved in the case is to completely ignore reality.

In connection with the foregoing, it should be remembered that *Anderson* v. *Helvering*, 310 U. S. 404, 407, holds "that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable."

It is axiomatic that a deduction for depletion belongs to the person owning the mineral which is depleted by production. The Treasury Regulations (Reg. 103, Sec. 19-23(m)-1) provide that " the owner of an economic interest * * * is allowed annual depletion deductions."

IV.

The action of the Circuit Court of Appeals in resting its opinion on the ground that a well had to be drilled as a condition precedent to the vesting of Howell's interest is in conflict with the established law and practice of the oil industry.

The requirement that a well be commenced before November 21, 1937, was in the nature of consideration given in exchange for the right to extract the mineral. The drilling of such "obligation" wells is a common method of paying for interests in oil-producing property. *Hugh Hodges Drilling Co.*, 43 B. T. A. 1045.

In G. C. M. 2270, wells had to be started at specific times and places, development had to be done, the property had to be maintained unencumbered, and payments had to be made out of oil. However, those conditions, as in the case at bar, were merely payments.

There is no requirement in the statute that a capital asset must be fully paid for before the holding period starts to run. The time begins when the property or right is acquired, not when it is paid for.

> "In other words, the two-year period mentioned in section 208(a)(8) begins to run from the date of petitioner's acquisition of the property, and not from the date of payment therefor or the date when additional costs is respect thereof were incurred." *John C. Shaffer*, 28 B. T. A. 1294, 1309.

There is nothing unusual in the Howell transaction because Howell was required to take additional action after acquiring his right to enter and explore in order to retain that right. The same condition exists in connection with practically all commercial oil and gas leases, which ordinarily provide:

(a) The original consideration pays for the rights for a designated period of time, usually a year.

(b) A well must be drilled, or a rental paid, if the rights are to be extended beyond the original period.

(c) A rental must be paid for each year or other period in the absence of a well.

(d) If oil is discovered, continuous and orderly development of the lease must be conducted.

(e) Boundary wells on adjoining property must be immediately offset.

(f) The lessee must not cease to produce oil from the lease after the term of the lease, but must continue to produce as long as oil can be produced in commercial quantities.

In other words, persons owning "economic interests" in oil leases must continue to perform under those leases or their rights lapse. That is exactly the situation in the case at bar.

V.

The decision of the Circuit Court of Appeals will cause confusion and uncertainty regarding the taxability of oil transactions which will restrict such transactions and detrimentally affect the public revenue.

In this case, Howell fully understood that the taxation of oil and gas transactions depended upon ownership and transfer of the "economic interest." He and all others in the oil industry have every reason to so understand because of the repeated decisions of this Court. It will be a cruel thing, because Howell had faith in the decisions of this Court, if such decisions are disregarded and his widow is compelled to pay an additional tax of nearly $20,000, plus interest.

The greatest public criticism of income taxation is its complexity and uncertainty. Such complexity and uncertainty as reflected by the statute should not be increased by a complete disregard of this Court's decisions on the thoroughly settled question of "economic interests" in

mining properties. If such a condition is permitted, taxpayers will be discouraged from engaging in taxable transactions. The purpose of the capital gains section will thus be defeated[1] and the public revenue adversely affected.

VI.

The decision of the Circuit Court of Appeals is in conflict with McFeely v. Commissioner, 296 U. S. 102.

In the *McFeely* case, the Commissioner contended that, for capital gains purposes, ownership of property acquired from a decedent through intestacy dates from the time of distribution, and not from the time of the decedent's death. This Court rejected the contention, stating the result "would be to penalize the taxpayer by lengthening the period during which the capital asset must be held in what is really a single ownership to obtain the advantage of the reduced tax" (p. 111).

Stated another way, in the *McFeely* case the Commissioner insisted, as he insists here, that legal title governs. This Court held that the date of decedent's death governs, irrespective of local law regarding the passing of title to legatees or next of kin.

In the case at bar, the action of the Circuit Court of Appeals, in basing its decision on acquisition of formal legal title, is in conflict with the principle of the *McFeely* case.

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[1] The purpose of the capital gains section is for "encouraging profit-taking sales of capital investments." *Helvering* v. *Hammel*, 311 U. S. 504, 509.

BRIEF IN SUPPORT OF PETITION FOR WRITS OF CERTIORARI.

OPINIONS BELOW.

The opinion of the Circuit Court of Appeals is not, as yet officially reported, but appears in the record at pages 69-75. The Memorandum Findings of Fact and Opinion of The Tax Court are not officially reported, but appear in the record at pages 15-23.

JURISDICTION.

The jurisdiction of this Court is discussed at page 2 hereof.

STATUTE INVOLVED.

REVENUE ACT of 1938:
Sec. 117. CAPITAL GAINS AND LOSSES.

(a) Definitions.—As used in this title:

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1);

* * *

(4) Long-Term Capital Gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * *

(b) Percentage Taken Into Account.—In the case of a taxpayer other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

* * *

66 2/3 percentum if the capital asset has been held for more than 18 months but not for more than 24 months;

* * *

SPECIFICATION OF ERRORS.

1. The Circuit Court of Appeals erred in holding that the income here involved is not long-term capital gain.

2. The Circuit Court of Appeals erred in holding that Howell did not acquire an "economic interest" in the mineral on October 6, 1937.

3. The Circuit Court of Appeals erred in holding that Howell had no rights prior to November 16 or 17, 1937.

STATEMENT OF THE CASE.

The facts are briefly set forth at pages 3 to 6 hereof. In more detail, they are:

The taxpayer, Katie M. Howell, is an individual whose address is Electra, Texas. She is the duly appointed and acting Executrix of the estate of her deceased husband, J. H. Howell. The income tax returns of Katie M. Howell and J. H. Howell were filed on the community property basis with the Collector of Internal Revenue for the Second District of Texas (R. 15, 16).

October 5, 1937, petitioner's husband, J. H. Howell, and one W. P. Ferguson reached an understanding with respect to a contract and an oil and gas lease covering certain of Ferguson's land.

The said contract and lease were executed October 6, 1937. The contract provides (R. 28, 29):

"This contract and agreement made and entered into, this 6th day of October, A. D., 1937, by and between W. P. Ferguson of Wichita County, Texas, hereinafter called Party of the First Part, and J. H. Howell of Wichita County, Texas, hereinafter called Party of the Second Par:

"Witnesseth, said First Party is the owner of the following described land situated in Wichita County, Texas:

"All of Blocks Nos. Five (5), Seven (7), Eight (8), Nine (9), Ten (10) and Eleven (11) of the W. P. Ferguson Subdivision of the North 966 acres of the East 1800 acres of the W. H. Spillers Survey, Abstract No. 257, which said subdivision plat is of record in the Deed Records of Wichita County, Texas, and said blocks above numbered containing an aggregate of five hundred, sixteen (516) acres, more or less—

"Said Second Party herein desires to drill a well, or cause a well to be drilled on the above described tract of land:

"Now, Therefore, for and in consideration of the payment by said Second Party herein of the sum of $1.00, and other covenants and agreements hereinafter set forth, said First Party agrees to execute and place in escrow in the First National Bank of Wichita Falls, Texas, oil and gas lease covering the above described tract of land, in favor of said second party; and the said Second Party hereby agrees that he will, on or before the 21st day of November, 1937, commence the actual drilling of a well on the tract of land above described, said well to be drilled with due diligence to a depth of 4000 feet, or to a sufficient depth to test what is known as the K-M-A deep sand. In the event production of oil or gas be found in paying quantities at a lesser depth than that herein set forth, it is agreed that second party shall have the privilege of completing such well at such lesser depth, but it is further agreed that in such event, said Second Party shall, within sixty days from the completion of a well at any lesser depth, start the actual drilling of another well to be drilled to the original depth set forth herein; in other words it is the intent hereof that said Second Party shall drill a well to test the 4000 foot sand, or

what is known as the K-M-A deep sand, to fulfill the requirements of this contract.

"The lease mentioned herein is to be for a period of three years, with annual rental of $1.00 per acre; and said lease is to be delivered to said second party at the time said well is actually started.

"In Witness Whereof we have hereunto set our hands this the 6th day of October, A. D. 1937."

The lease is on the customary Texas "Producer's '88' Special Form." It provides, in the filled-in printed portion, that a well be commenced on or before October 6, 1937, the date of the lease. At the bottom of the first page, the lease contains the following typewritten statement (R. 30):

> "As a further consideration, lessee herein agrees that he will commence the actual drilling of a well on or before November 21st, 1937, on the above described acreage; said well to be drilled to a depth sufficient to test the 4000 foot or K-M-A deep sand, according to contract attached hereto and made a part hereof."

The lease was not placed in escrow with the First National Bank of Wichita Falls, Texas, as provided in the contract, but by mutual consent of the parties was left with one H. S. Gray. Under the agreement of October 5, 1937, Gray was to receive a lease on 20 acres of the land included in Ferguson's lease to petitioner's husband, J. H. Howell (R. 16-17, 39-46).

On October 26, 1937, petitioner's husband, J. H. Howell, entered into an agreement with the Consolidated Oil Company, under which he agreed "to convey to you an undivided 3/4th interest in the acreage covered by contract between myself and W. P. Ferguson, dated October 6, 1937, you to assume all the obligations contained in contract dated the same date * * *." Consolidated paid petitioner's husband $5,000 in cash in consideration for the said agreement and agreed to drill the "obligation" well (R. 18, 47-48).

The well was actually started on November 16 or 17, 1937, and on the same day Gray delivered the lease to petitioner's husband. On November 19, 1937, Howell assigned an undivided 3/4ths interest in the lease to Consolidated Oil Company. On the same date, Howell and Consolidated assigned to Gray all of their interests in the oil and gas lease insofar as it covered a described tract of land containing twenty acres, more or less (R. 18, 37-38).

On April 10, 1939, petitioner's husband, J. H. Howell, and Consolidated sold to Buffalo Oil Company their entire 7/8ths working interest in about half of the land covered by the lease. The consideration was $700,000 cash, of which Howell received $175,000 (R. 18, 38).

The Tax Court took the position that the thing owned and sold by Howell was the "lease"; that as Howell did not secure the piece of paper called a "lease" until November 16 or 17, 1937, he had held the property for less than eighteen months. The Circuit Court of Appeals followed the same reasoning, but went further. It held that oil in place was the thing sold, stating (R. 73):

> "Under the law of Texas an oil lease is a present sale of oil and gas in place. That is the substance of what taxpayer acquired when the lease in question was delivered. That is what the taxpayer sold to Buffalo Oil Company. The purchasers did not pay $700,000.00 for an 'economic interest.' They paid $700,000.00 for oil and gas in place, plus the right to take it, as evidenced and made secure to them by the execution and delivery to them of a valid and legal document, to-wit a lease."

The language quoted is the identical contention made to and rejected by this Court in *Burnet* v. *Harmel*, 287 U. S. 103.

Neither Court below cited any oil, gas or mineral decisions to support the position taken.

The taxpayer contends the only thing of value involved was the "economic interest," or right to enter upon the

land, explore for and extract the mineral. Certainly Consolidated paid Howell $5,000 and agreed to drill the "obligation" well for that "economic interest," because Howell did not have the "lease" at that time.

ARGUMENT.

Petitioner's case is outlined under "Reasons Relied On for the Allowance of the Writs," pages 5 to 12, supra. Any further statement would merely be a verbose statement of the same argument. Consequently, further argument will be eliminated.

CONCLUSION.

For the reasons stated, writs of certiorari should issue to resolve the conflicts mentioned, and to dispose of the case in accordance with the accepted and usual course of judicial proceedings.

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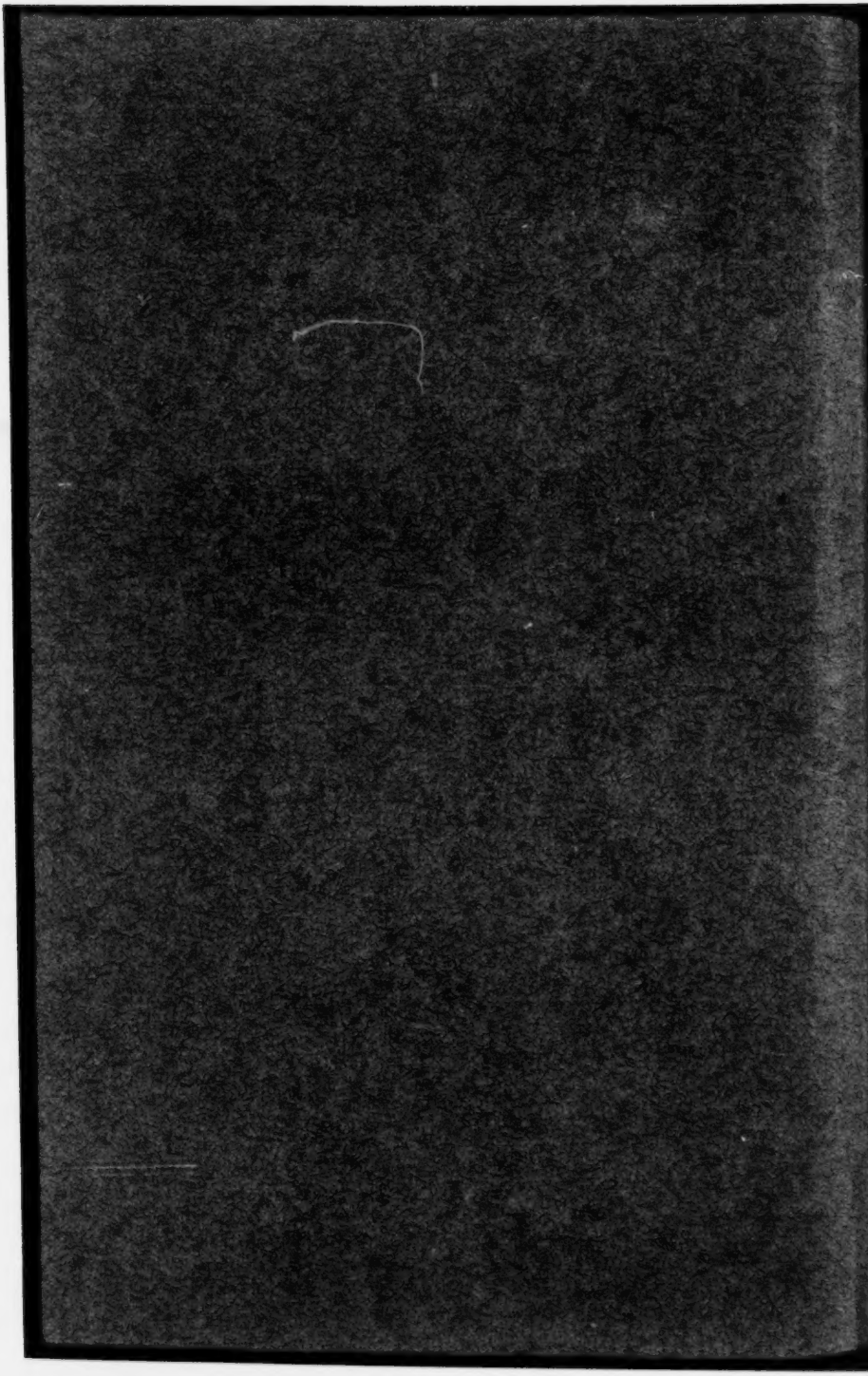
March, 1944.

In the Supreme Court of the United States



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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 824

KATIE M. HOWELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 825

ESTATE OF J. H. HOWELL, DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 15–23) is not reported. The opinion of the Circuit Court of Appeals (R. 69–75) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 8, 1944 (R. 75). The petition for writs of certiorari was filed March 29, 1944.[1] The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

A contract executed concurrently with an oil and gas lease provided that the lease was to be held in escrow and was not to be delivered unless the lessee started drilling a well on the property by a specified date. The question is whether, in computing the taxable percentage of the gain realized upon a sale of the leasehold interest under Section 117 of the Internal Revenue Code, the holding period is to be measured from the date the lease was executed or from the date it was delivered by the escrow agent upon commencement of the drilling.

STATUTE INVOLVED

Internal Revenue Code:

> SEC. 117. CAPITAL GAINS AND LOSSES.
>
> (a) *Definitions.*—As used in this chapter—
>
> * * * * *

[1] These are companion cases involving identical issues, the returns having been filed on the community property basis. The cases were consolidated for hearing and disposed of as one case by both the Tax Court (R. 15) and the Circuit Court of Appeals (R. 63–65), and by stipulation (R. 76) only the record in No. 824 has been printed.

(2) *Short-Term Capital Gain.*—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months * * *

* * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months; 66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

* * * * *

(26 U. S. C., Sec. 117.)

STATEMENT

On October 6, 1937, one Ferguson entered into a contract with J. H. Howell, the petitioner's husband, which recited that Ferguson as party of the first part was the owner of certain land in Wichita County, Texas, and that Howell as party of the second part desired to drill a well on the land (R. 16, 44–46). The contract then provided (R. 16–17, 45–46):

> Now, Therefore, for and in consideration of the payment by said Second Party herein of the sum of $1.00, and other covenants and agreements hereinafter set forth, said First Party agrees to execute and place in escrow in the First National Bank of Wichita Falls, Texas, oil and gas lease covering the above described tract of land, in favor of said Second Party; and said Second Party hereby agrees that he will, on or before the 21st day of November, 1937, commence the actual drilling of a well on the tract of land above described, said well to be drilled with due diligence to a depth of 4,000 feet, or to a sufficient depth to test what is known as the K–M–A deep sand. * * *
>
> The lease mentioned herein is to be for a period of three years, with annual rental of $1.00 per acre; and said lease is to be delivered to said second party at the time said well is actually started.

On the same date, October 6, 1937, Ferguson executed an "Oil and Gas Lease" in favor of Howell, covering the land described in the above contract, substantially in accordance with the provisions of the contract (R. 17, 39–44). The lease, among other things, obligated the lessee to deliver to the lessor one-eighth part of the oil and gas produced, and contained the following additional provision (R. 17, 43):

> As a further consideration, lessee herein agrees that he will commence the actual drilling of a well on or before November

> 21st, 1937, on the above described acreage; said well to be drilled to a depth sufficient to test the 4,000 foot or K–M–A deep sand, according to contract attached hereto and made a part hereof.

The lease was not placed in escrow with the First National Bank, but by mutual consent was left with one Gray as escrow agent. Gray was office manager for Ferguson and also an independent oil producer. Gray was instructed to return the lease instrument to Ferguson if no well was actually started by November 21, 1937. The parties also agreed that, if and when the lease became valid upon commencement of the drilling of a well within the specified time, Gray should receive an interest in 20 acres out of the lease. (R. 17.)

On October 26, 1937, Howell entered into an agreement with Consolidated Oil Company whereby he agreed to convey to Consolidated an undivided three-fourths interest "in the 'acreage' covered by * * * contract" of October 6, 1937, between himself and Ferguson, in consideration of a cash payment and the assumption by Consolidated of Howell's obligations under the contract (R. 18, 52–53).

On November 16 or 17, 1937, a well was actually started and on the same day Gray delivered the lease to Howell (R. 18). On November 19, 1937, the lease and contract were filed for record in the office of the county clerk for Wichita County,

Texas (R. 17). On the same day, November 19, 1937, Howell by written assignment reciting that "the said lease and all rights thereunder or incident thereto are now owned" by him, conveyed to Consolidated an undivided three-fourth interest in the lease (R. 18, 53–54). Also on that same day, Howell and Consolidated assigned to Gray their interest in the lease with respect to a certain tract containing 20 acres (R. 18, 56–58).

On April 10, 1939, Howell and Consolidated sold their combined interest in the lease to Buffalo Oil Company for $700,000 cash (R. 18–19, 56–58).

The income tax returns filed by Howell and his wife on the community property basis disclosed a community profit of $160,146.67 derived from the sale of their interest in the Ferguson lease. Only 66⅔ percent of this gain was reported as taxable income, on the theory that the amount so reported represented a long-term capital gain derived from the sale of a capital asset held for more than 18 months, but not more than 24 months. (R. 19–20.) The Commissioner determined that the amount reported represented short-term capital gain, taxable to the extent of 100 percent. The Tax Court sustained the Commissioner's determination (R. 23–24). The Circuit Court of Appeals affirmed (R. 75).

ARGUMENT

This case turns upon the application of the familiar principle that ownership of property

passes when the contracting parties so intend. It presents neither a conflict nor a question of general importance.

1. The only issue presented is the length of time the leasehold interest sold in 1939 had been "held" within the meaning of Section 117 of the Internal Revenue Code. The question narrows itself to one of when Howell acquired ownership of the lease, since within the meaning of the statute "to hold property is to own it." *McFeely* v. *Commissioner,* 296 U. S. 102, 107. See also *Helvering* v. *San Joaquin Co.,* 297 U. S. 496, 499. It has been uniformly held that the holding period of capital assets acquired by contract commences when ownership is acquired, and that the time of acquisition of ownership depends upon the intention of the parties as gathered from the contract and the surrounding circumstances. *Shillinglaw* v. *Commissioner,* 99 F. 2d 87 (C. C. A. 6th), certiorari denied, 306 U. S. 635; *Commissioner* v. *C. A. Sporl & Co.,* 118 F. 2d 283 (C. C. A. 5th); *Shattuck* v. *Helvering,* 119 F. 2d 902 (C. C. A. 2d); *Sommers* v. *Commissioner,* 63 F. 2d 551 (C. C. A. 10th). Cf. *Commissioner* v. *Cummings,* 77 F. 2d 670 (C. C. A. 5th); *Bothwell* v. *Commissioner,* 77 F. 2d 35 (C. C. A. 10th).

The record fully supports the conclusion of the courts below that Howell's ownership of the lease was conditional upon the starting of a well by November 21, 1937, and that he did not acquire

ownership until that condition was fulfilled on November 16 or 17, 1937. The contract executed on October 6, 1937, concurrently with the lease provided that the lease was to be placed in escrow, that Howell should commence drilling a well on or before November 21, 1937, and that the lease was to be delivered "at the time said well is actually started" (R. 16–17, 44–46). These provisions are unequivocal and leave no room for doubt that the parties intended ownership of the leasehold interest to pass only if and when the stipulated condition precedent was performed. Had they intended ownership to vest immediately upon execution of the lease, as petitioner contends, the separate contract would have been entirely superfluous.[2]

The contract was given full effect by the parties. The lease was placed in escrow with instructions that the escrow agent return it to the lessor if a well was not started by the specified date (R. 17). On November 16 or 17, 1937, a well was started

[2] At least two important effects of the separate contract may be noted: (1) Under the lease the lessee had the option of paying a stipulated annual rental in lieu of commencing a well (R. 41–42), whereas under the contract he was obligated to commence drilling as a condition precedent to obtaining delivery and ownership of the lease (R. 45–46); (2) since under Texas law an oil and gas lease operates as a present sale of the oil and gas in place (*Burnet* v. *Harmel*, 287 U. S. 103), the contract postponed such sale until ownership of the leasehold interest passed to the lessee upon performance of the condition.

and the escrow agent delivered the lease (R. 18). Prior to that event Howell had conveyed to Consolidated Oil Company a three-fourths interest in his "contract" (R. 18, 53); only after the condition precedent was performed and the lease delivered could he assign to that company a three-fourths interest in the lease itself, which he did by an instrument reciting that "said lease and all rights thereunder or incident thereto are now owned" by him (R. 18, 54). And it was not until after the the condition was performed that the lease was recorded (R. 17), and that Howell and Consolidated joined in a conveyance to Gray, the escrow agent, of a 20-acre interest in the lease (R. 18, 47–49).

2. Petitioner asserts (Pet. 5–7) conflict with *Burnet* v. *Harmel,* 287 U. S. 103, and related authorities. Those cases are not concerned with the issue here presented. They involve consideration of *what* economic interests pass to a lessee of oil and gas lands, rather than *when* those interests pass. None of them deals with the holding period. As the court below pointed out, petitioner fails to distinguish between an absolute and a conditional lease; between a contract right to enter upon the land in order to perform a condition precedent to ownership of the lease, and the lease-

hold interest itself.[5] The asset which was sold in 1939 and from which the capital gain was derived was not the right to enter upon the land to perform the condition, but the leasehold interest. That asset was not acquired and "held" until the condition was performed and the lease delivered by the escrow agent.

3. The decision below is not, as petitioner asserts (Pet. 12), in conflict with *McFeely* v. *Commissioner, supra.* On the contrary, the court below in its opinion properly relied upon that case. This Court there held that to "hold" property is to own it, and that property acquired from a decedent through intestacy or general bequest was owned, and therefore "held," from the date of the decedent's death. Where, as here, property is acquired by contract, the holding period likewise commences when ownership is acquired; in such case, however, the date of acquisition of ownership necessarily depends upon the intention of

[5] It is axiomatic that where a written instrument is executed and placed in escrow for delivery at a future date on performance of a condition, the date of delivery marks the effective date of the instrument. Restatement of the Law of Contracts, Secs. 101 and 103. This familiar principle is well recognized in Texas, where the contract in the instant case was executed and was to be performed, and an oil lease is no exception to the rule. *Norman* v. *Wilson*, 41 S. W. 2d 331 (Tex. Civ. App.); *Bott* v. *Wright*, 62 Tex. Civ. App. 632. Cf. *Sutton* v. *Commissioner*, 95 F. 2d 845, 848–849 (C. C. A. 10th).

the contracting parties. *Shilinglaw* v. *Commissioner, supra; Shattuck* v. *Helvering, supra.* Cf. *Helvering* v. *San Joaquin Co., supra.*

4. Petitioner's reliance (Pet. 8–9) upon G. C. M. 2270, VI–2 Cum. Bull. 216 (1927), is misplaced. It dealt not with the issue here involved, but with allowances for a depletion, and the purpose, the nature, and the effect of the escrow agreement there considered were different. Moreover, even if it were applicable here, it would lack the force of a regulation and would not, as petitioner suggests, represent an established administrative construction. Cf. *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455.

CONCLUSION

The decision of the court below is correct and there is no conflict of decisions. The case is not of general importance and turns upon its own particular facts. The petition should be denied.

Respectfully submitted.

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COMMISSIONER OF INTERNAL REVENUE.

On Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

PETITIONER'S REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

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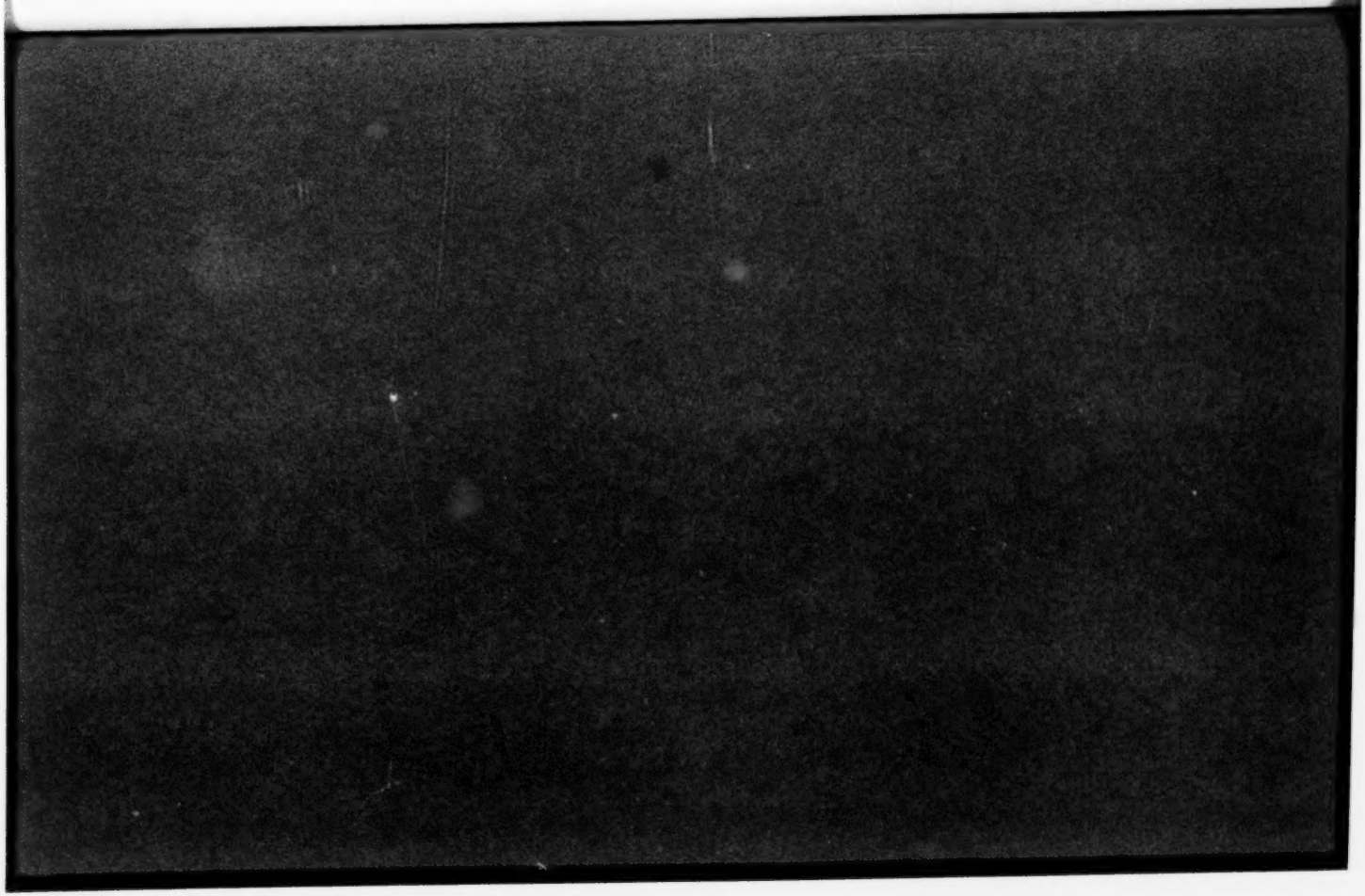

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PETITIONER'S REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

Respondent's brief is predicated entirely on the assumption that from October 6, 1937, until November 16 or 17, 1937, Howell owned nothing which was salable.

That Howell did own something and that petitioner's position is correct is shown by what actually happened in

this case. On October 26, 1937, Howell transferred an undivided three-fourths interest in the "acreage" to Consolidated Oil Company for $5,000.00 in cash, and Consolidated assumed all the obligations under the contract, including the drilling of the "obligation" well. (R. 52, 53.) It is plain nonsense to say that Howell did not own the "economic interest" at that time. Consolidated certainly thought so when it paid $5,000.00 cash and undertook to drill a well 4,000 feet deep. Yet the respondent argues that Howell owned nothing until the well was started by Consolidated.

At all times from October 6, 1937, Howell owned the only thing of value involved—i.e., the right to enter upon and exploit the land. The fact that he had to pay for that right later does not detract from his title to it.

Conflict with Burnet v. Harmel, 287 U. S. 103.

The respondent's brief (p. 9) states the *Harmel* case is not applicable because that case involves "*what* economic interests pass to a lessee of oil and gas lands, rather than *when* those interests pass."

Petitioner insists that *what* economic interest Howell acquired on October 6, 1937, is the point involved in this case. If, as petitioner contends, the thing involved is the "economic interest" as defined by this Court in numerous oil and gas cases, the question of *when* that interest passed is automatically disposed of. If the thing involved is the right to enter upon the land and exploit it for oil ("economic interest") justice and adherence to this Court's decisions demand that the writs issue.

In the *Harmel* case, the Government successfully contended that, in determining the capital gains question involved, it was not "bound by the decision of the Texas courts that leases of oil lands constitute sales of the oil."[1] This Court fully accepted that argument and held that an

[1] Brief for the Commissioner, page 5, *Burnet* v. *Harmel*, No. 26, October Term, 1932.

oil and gas lease gave the lessee "the right to enter upon and use the land for the purpose of exploiting it."[2]

The case at bar turned squarely on the determination that the thing sold was oil and gas in place. (R. 73.)

The Decision Below is in Conflict with Established Bureau Practice.

The respondent's brief (P. 11) states that petitioner's reliance on G.C.M. 2270, VI-2 Cum. Bull. 216 (1937), "is misplaced." It should be noted that the respondent does not say that G.C.M. 2270 does not represent established Bureau policy, but merely says that, if applicable, it would lack the force of a regulation.

The truth is that the Bureau consistently has held, and still holds, that where a lease is placed in escrow conditioned upon the drilling of a well, or the fulfillment of other obligations, all of the incidents of ownership belong to the vendees from the time the lease is placed in escrow. The escrow arrangement is simply to assure the vendors that the conditions will be carried out.

Respondent's brief makes a general statement that the nature and effect of the escrow agreement in G.C.M. 2270 were different than in the case at bar, but fails to state the difference. The fact is that the conditions were much more severe than in this case because, in the transaction referred to in G.C.M. 2270:

1. Several wells, rather than one well, had to be started.

2. Stipulated development of various kinds had to be done.

3. The property had to be maintained unencumbered with liens.

4. Certain payments had to be made out of oil produced from the property.

---

[2] 287 U. S. 103, 111.

Despite all of the foregoing, the General Counsel of the Bureau held the vendees had "every right of ownership." Under the rule of the case at bar, the vendees would have owned nothing until all of the conditions of the escrow agreement were complied with.

An effort is made to muddy the waters by stating[1] "It is axiomatic that where a written instrument is executed and placed in escrow for delivery at a future date on the performance of a condition, the date of delivery marks the effective date of the instrument." The quoted statement applies only when no rights pass prior to the release of the instrument from escrow. In this case, the taxpayer had the right to enter upon and exploit the land beginning October 6, 1937. The escrow was simply to secure payment for the rights which passed. This is ably pointed out in G.C.M. 2270.

It really is axiomatic that two instruments executed at the same time and referring to each other must be construed together. *Littlefield* v. *Perry*, 21 Wall. (88 U. S.) 205, 220. That rule should be followed in this case.

The Decision of the Court Below is in Conflict with the Established Law and Practice of the Oil Industry.

The respondent's brief is silent on petitioner's argument that the reasoning of the Court below is in conflict with the established law and practice of the oil industry. Petitioner's petition, at pages 10 and 11, clearly shows that such is the fact.

The Cases Cited by Respondent (p. 7) to Sustain the Contention that "to Hold Property is to Own it" Are Not Oil Cases and All Are Clearly Distinguishable on Their Facts.

Respondent's brief does not cite a single oil, gas or mineral decision to support his position. This is true because the decisions listed in the petition sustain petitioner's posi-

[1] Footnote, page 11, respondent's brief.

tion and cannot be distinguished. All the cases cited by respondent are easily distinguished and have no bearing on an oil and gas transaction.

McFeely v. *Commissioner*, 296 U. S. 102, is discussed at page 12 of the petition. It decides that property acquired through intestacy is held, for capital gains purposes, from the date of decedent's death, and not from the time legal title passes through distribution. The case supports petitioner's position.

Helvering v. *San Joaquin Co.*, 297 U. S. 496, involved an option to purchase land in fee. No option is involved in this case.

Shillinglaw v. *Commissioner*, 99 F. (2d) 87, involved a contract to purchase stock, with the seller to have thirty days within which to deliver, and the buyer was not compelled to accept if the surplus as shown by an examination was less than a represented amount.

Commissioner v. *C. A. Sporl & Co.*, 118 F. (2d) 283, involved a situation where the taxpayer, in settlement of a debt due it, received, on October 13, 1931, $14,235.50 cash and an agreement and understanding that the debtor would issue $56,700.00 in second mortgage bonds. The bonds were issued in February, 1932. The Fifth Circuit held the bonds were owned from October 13, 1931. This case definitely supports petitioner's position that rights, and not legal title, should prevail.

In *Shattuck* v. *Helvering*, 119 F. (2d) 902, the question was when a bailment ceased.

Sommers v. *Commissioner*, 63 F. (2d) 551, involves a situation where certain stock was subscribed for, but "that agreement was binding on the subscribers, but not on the corporation." In view of that situation, the Court properly held that ownership of the stock began when the stock was actually issued.

Commissioner v. *Cummings,* 77 F. (2d) 670, involves a situation where a taxpayer acquired option warrants to purchase stock. The Court held ownership of the stock dates from the date of the acquisition of the stock, and not from the date the option warrants were acquired.

Bothwell v. *Commissioner,* 77 F. (2d) 35, likewise involves an option to purchase stock. Ownership was held to date from the date the stock was acquired as a result of the exercise of the option.

Conclusion.

For the reasons stated in the petition and in this reply, the writs should be granted.

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April 26, 1944.